

THE CNMV ADVISORY COMMITTEE'S COMMENTS ON THE CESR CONSULTATION ON CLARIFICATION OF DEFINITIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

(Ref: CESR/05-490b)

The CESR has made very positive changes with respect to the first consultation paper after analysing in detail the opinions it received.

The main changes were as follows: the concept of asset liquidity has been eliminated while that of portfolio liquidity has been accepted, and the presumption of liquidity for listed securities has been accepted, although listing does not guarantee liquidity; the look-through approach appears to have been rejected, so investments can be made in closed end real estate funds; systems based on amortised cost methodology have been accepted, although the issuer's credit spread needs to be updated; "program" has been included in addition to "issuance," so more information is available on money market instrument issues; clearer requirements and objectives have been established so that UCITS can assess whether or not the requirements in the countries where money market instruments are issued are at least equivalent to those of the European Union; the CESR mentions that the derivatives used under article 19 are not implicitly subject to the efficient portfolio management requirements of article 21(2), so the *"techniques and instruments"* concept is interpreted on a broad basis; a last indent was included in paragraph 6, providing for tailored control of embedded derivatives; and the CESR has established that derivatives on any financial index that meet the relevant criteria may be considered eligible, even those referenced to financial derivatives on commodities. However, it appears that the CESR does not accept hedge fund indices as eligible. Lastly, the CESR proposes the inclusion of standard formulas for calculating the quality of index replication.

Nevertheless, the CNMV Advisory Committee believes that there are still some factors that should be reconsidered by the CESR:

- **The exemption from the liquidity requirement in other eligible instruments has not been considered (Box 2).**

The liquidity factor is applicable but only to conform to the requirements of article 37. The CNMV Advisory Committee asked for an exemption from the liquidity requirement but the CESR has not complied. The approach in Box 2 has changed: the eligibility criteria are detailed specifically, instead of by reference to Box 1.

The following criteria cause or may cause problems: the security must be freely negotiable on the capital markets, and there must be *"regular and accurate"* information available to the market on the security.

- **Simultaneous compliance with the requirements established for money market instruments is required (Box 4).**

Level 2 of the CESR document is less specific about the liquidity criterion (now the other requirements are Level 3), but compliance with the requirements must be cumulative and simultaneous. The requirements have been divided into those relating to the UCITS itself and those relating to each instrument or asset in its portfolio.

Level 3 (page 22 of the text, paragraph on the criterion *"value which can be determined at any time"*, including the two indents) deals with the same matter in greater detail. It seems to have resolved the previous problems but the new wording should be reviewed to see if there are any new problems. For example, the penultimate paragraph of Box 4 requires that the issuer's credit spread be updated *"if necessary"*. Might this requirement pose a problem?

The requirement of *"maturity at issuance of less than 12 months"* was introduced instead of the criterion *"normally dealt in on the money market"* in the third indent of paragraph one of

Box 4 (Level 2).

- **Definition of "embedded derivative" based on IAS 39 (Box 11).**

The CESR maintains its definition based on IAS 39. Nevertheless, it added a third indent to paragraph 1, stating that embedded derivatives have "*a significant impact on the risk profile and pricing of the transferable security or money market instrument*". However, this does not define the scope of embedded derivatives since it is vague (when is the impact "significant"?).

The instrument list (now Level 3) has not changed. A positive inclusion is the last indent of paragraph 6, where the CESR tries to mitigate the requirements to some extent by stating that the "*requirement to check compliance... will depend on the characteristics of the embedded derivative and on its impact on the risk profile and pricing of the hybrid instrument. If this impact is not significant, controls can be tailored accordingly*". This, combined with paragraph 102 of the explanatory text, tries to limit the impact of the regulation but it is still very vague. The suggestion to introduce a waiver for UCITS that invest less than 10% of their assets in embedded derivatives was also rejected since this does not conform to the Directive.

- **The fifth indent of paragraph 2, "restrictions on third-party management", is maintained, which could seriously jeopardise investments in those UCITS (Box 12).**
- **The text includes definitions of the "process for independent assessment of the value of OTC derivatives" and their "reliable and verifiable valuation on a daily basis".**

Here, CESR oversteps the Commission's mandate and Level 2 is used to regulate the index management process. Sections ii) and iii) are also very problematic (Box 15).

The suggestions to eliminate the need for assessment by an "*independent third party*" and a "*daily*" valuation were rejected by the CESR.

Box 15 was extended significantly in order to include definitions of the "*process for accurate and independent assessment of the value of OTC derivatives*" and their "*reliable and verifiable valuation on a daily basis*" (paragraphs 2 and 3). Here, the CESR also appears to have exceeded the Commission's mandate and uses Level 2 to regulate the index management process. Specifically, the second indent of paragraph 2 of Box 15 poses serious problems regarding the role of the depository in valuing OTC derivatives (problems not even mentioned in the Commission's Recommendation on the use of derivatives).

The second and third indent of paragraph 3 are problematic: in the second indent, the CESR establishes that the valuation of the derivative made by the counterparty be checked against that performed by an independent third party; in the third indent of paragraph 3, the CESR establishes, as an alternative, that the valuation be performed by "an independent third unit within the UCITS". The wording and the definition of "independent" are not clear. The last indent of box 15 seems excessively normative.

- **The practical problems of asymmetric risks have not been considered (Box 16).**

The CESR has not considered the suggestions on asymmetric risks and continues to ignore their inherent practical problems.

On the other hand, the CESR takes the opportunity once again to exceed its mandate and apply Level 2 to the risk management process (paragraph 3); this time it adds the need to consider the risks of information asymmetry for credit derivatives, especially in the case of group undertakings.

- **Lastly, the definition of diversification of index UCITS has not been made more flexible (Box 18).**

The CESR has not included the suggestion to change the text of box 18 in order to make

the definition of diversification more flexible. In this respect, the CESR once again mentions the IOSCO report on indexation.